

Sanitized Copy Approved for Release 2010/05/03 : CIA-RDP87T00759R000100110017-7

THE WHITE HOUSE
WASHINGTON

July 31, 1985

NOTE FOR WILLIAM J. CASEY

FROM: ROGER B. PORTER *RBP*

The agenda and papers for the
August 1 Meeting of the Economic
Policy Council are attached.

ON FILE NSC RELEASE INSTRUCTIONS APPLY

Sanitized Copy Approved for Release 2010/05/03 : CIA-RDP87T00759R000100110017-7

EXECUTIVE SECRETARIAT
ROUTING SLIP

1 Aug 85

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
2	DDCI				
3	EXDIR				
4	D/ICS				
5	DDI				
6	DDA				
7	DDO				
8	DDS&T				
9	DD/NIC				
10	DD				
11	DD				
12	DD				
13	D/OE				
14	D/PAO				
15	VC/NIC				
16	NIO/ECON	X			
17					
18					
19					
20					
21					
22					

SUSPENSE

Date

Remarks

No action

Executive Secretary

1 Aug 85

Date

3637 (10-81)

STAT

Executive Registry

85- 3019

THE WHITE HOUSE

WASHINGTON

July 31, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: ROGER B. PORTER *RB*

SUBJECT: Agenda and Papers for the August 1 Meeting

The agenda and papers for the August 1 meeting of the Economic Policy Council are attached. The meeting is scheduled for 11:00 a.m. in the Cabinet Room.

The first agenda item is an update on farm conditions and the status of the 1985 farm bill. A paper describing the environment in which the farm bill is being drafted and how that environment is affecting the farm bill is attached.

The second agenda item concerns current farm credit conditions. The Economic Policy Council has reviewed the causes and effects of the current agricultural credit problems and outlined several options for dealing with the problems. A paper describing the extent and cause of the problems and outlining specific options with regard to the Farmers Home Administration (FmHA) and the Farm Credit System (FCS) is attached.

Attachments

THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

11:00 a.m.

The Cabinet Room

AGENDA

1. The Farm Bill
2. Farm Credit Conditions

THE WHITE HOUSE

WASHINGTON

July 31, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: ECONOMIC POLICY COUNCIL

SUBJECT: Current Economic Conditions in the Agricultural Sector and the 1985 Farm Bill

The Economic Policy Council recently met to review the current economic conditions in the agricultural sector and to discuss the current progress of the 1985 Farm Bill. The following provides an overview of the environment in which the Farm Bill is currently being drafted and reviews the status of Farm Bill deliberations in the Congress.

CURRENT ECONOMIC CONDITIONS

The Farm Sector In Transition

The farm sector is entering the fourth year of transition from the tight supplies and high prices of the 1970's to the large supplies and lagging prices of the 1980's. The transition was touched off by fundamental changes in agricultural supply and demand worldwide and has proven disruptive enough to put a growing number of farm operators under serious financial stress.

Many of the macroeconomic, policy, and weather factors that contributed to the expansionary market of the 1970's have worked in reverse so far in the 1980's. Growth in demand for farm products has averaged less than 1 percent per year in the 1980's compared with 3-4 percent in the 1970's. The sector's capacity to produce has continued to expand 2-3 percent per year in the 1980's, however, as investments made in the 1970's matured and high support rates weakened producer incentives to adjust to the changing market environment.

This growing imbalance between farming's capacity to produce and demand for its products has made the sector increasingly dependent on government price and income support programs to forestall a sharp drop off in farm returns. With a brief respite in 1983/84 due to PIK and the drought, commodity prices have stagnated in nominal terms and fallen more than 20 percent in real terms since 1980. The large stocks accumulated since 1980 suggest prices would have fallen significantly further without the U.S. Government loan program to underpin grain, oilseed, and cotton prices.

-2-

Farm income has also stagnated in nominal terms while falling a fifth in real terms. Income would also have fallen in nominal terms and declined further in real terms without increased support via direct government payments--up from \$2 billion per year in the late 1970's to \$7 billion in the 1980's--and indirectly via the loan program. Price and income support program costs have burgeoned more than the direct payment subtotal suggests -- from less than \$5 billion per year in the late 1970's to \$14 billion in the 1980's. These price, income, and costs developments contrast sharply with expectations of continued growth in farm returns and low program costs as recently as 1981.

Farm asset values have been under similar pressures but without support programs to mute their impact. The sharpest drops in asset values have been concentrated in real estate, with land values off more than a third in real terms since 1982 as developments in the macroeconomy reinforced developments within the sector.

The financial stress generated by this deterioration in prices, incomes, and assets has varied widely across subsectors within agriculture. While the sector as a whole showed a positive cashflow in 1984, 50 percent of operators did not have sufficient cash income from farm and off-farm sources to meet farm operating costs and family living expenses. While the sector as a whole has lost less than a third of the asset appreciation of the 1970's, almost 20 percent of operators have experienced enough asset erosion to push them into highly leveraged positions or technical insolvency. Roughly 12 percent of farmers concentrated in field crop and livestock operations in the Corn Belt, Lake States, and Northern Plains face serious enough cashflow and asset losses to jeopardize their continued operation.

Prospects for Further Adjustments

Prospects for further deterioration in the farm financial situation depend on developments in the major commodity markets, the macroeconomy, and the farm legislation passed later in the year. Developments in all three areas suggest that farm financial stress is likely to continue, possibly intensify, over the coming year.

The outlook for the major commodity markets is depressed. This year's large beginning stocks, excellent crop prospects, and lagging exports are adding to downward pressure on prices, incomes, and asset values. Without a severe drought comparable to 1983 or a sharp increase in exports comparable to the surges of the 1970's, commodity prices are likely to lag at or below loan levels.

-3-

Prospects for the macroeconomy also point to continued financial stress. Most macroeconomic analysts agree that the dollar will continue strong enough to discourage exports while interest rates are unlikely to fall far enough to reduce production expenses or stabilize asset values. Moreover, they also tend to agree that global economic growth will not be fast enough to generate a significant expansion in foreign demand for farm products.

Commodity prices would have to rise 20-30 percent to forestall further declines in incomes and land values. The cost of price supports high enough to prevent further declines, however, would be large -- possibly twice the 1980's \$14 billion per year average. Moreover, this would destroy agriculture's capacity to export, causing even greater problems of excess capacity. This is clearly not a viable alternative. In this environment, the sector could face continued financial pressure for 2-3 years more until sufficient resources leave the sector to bring agriculture's capacity to produce back into balance with demand for its products. Farm incomes could fall \$2-4 billion further (5 to 10 percent) despite large scale government payments while land values could slip another 10-20 percent. A drop in supports that allowed commodity prices to fall to market-clearing levels could result in even greater losses in farm incomes -- possibly \$6-8 billion -- and further drops in land values -- possibly 30-40 percent.

Agricultural Lender and Agribusiness Impacts

While operators facing both cash shortfalls and serious asset erosion make up only about 10 percent of farms, they account for more than 45 percent of farm debt. Their increased difficulty servicing this debt has become a serious problem for the farm credit system and agricultural banks. Agricultural lenders have also come under pressure directly as a result of declining asset values, deteriorating loan portfolios, and falling rental returns. These lenders play key roles in their local economies and, with the rural credit and banking system increasingly well integrated, further deterioration could spill over to hurt the broader rural economy in the most seriously affected states.

Farm financial problems are also affecting the rest of the agribusiness complex. Among input industries, machinery has been hardest hit as farmers cut back on purchases. Plant operations have been scaled back in many cases to less than half of capacity. The fertilizer industry is also depressed, with capacity utilization rates lagging in the 72-77 percent area. The transportation, processing and marketing subsectors are also facing an increasingly serious excess capacity problem with 15-20 percent of their plants unused.

-4-

PROGRESS ON THE 1985 FARM BILL

In early 1985 the Administration sent to the Congress a farm bill proposal that provided for market orientation by reducing price and income supports and tying them more closely to past movements in market prices. Supply control programs were to be phased out; a five-year transition period was provided to move from current programs to more market-oriented programs. The Administration's proposal would have cut budget outlays significantly while permitting the farm sector to regain export competitiveness by reducing price and income support levels. The proposal was perceived by the agricultural community and the Congress as too austere since the reduced price and income supports would result in a sharp drop in farm income in the short run. The proposal received no serious consideration by Congress and is effectively dead.

The Senate and House agriculture committees have been making up the 1985 Farm Bill for over three months now. Each committee has considered a wide range of proposed approaches to future farm policy. These include:

- o Imposition of mandatory supply controls on farmers;
- o Payment of direct income transfers to farmers while moving rapidly to a market-oriented agriculture;
- o A slower transition to market-orientation while retaining larger income supports than proposed by the Administration;
- o Retention of current price support loan programs, but permitting farmers to repay loans at market prices when they fall below the support levels.

After three months of work neither committee has reported out a farm bill, although both committees hope to report out bills before the August recess. No single approach to future farm policy is dominating the others. In general, the current status can be characterized as follows:

- o Agriculture committee members recognize that current farm programs are pricing U.S. producers out of world markets and that prices must fall to restore international competitiveness.
- o Committee members insist, however, that any new farm legislation must seek to maintain farm income.
- o Committee members acknowledge that getting the budget under control is essential, but they consider this less important than protecting farm income.

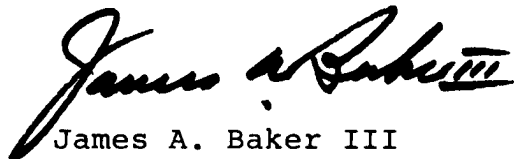
-5-

The Senate Budget Resolution provides some discipline at the approximately \$32 billion level as calculated by the CBO. (This is equivalent to the Administration's calculation of \$38 billion since we include a loss reserve for CCC export credit guarantees.) The proposals being considered by both committees cost out at over \$50 billion during FY 86-88.

The driving motivation of most Agriculture Committee members is to provide sufficient income transfer to farmers to quiet agricultural interests sufficiently far in advance of the 1986 election to ensure minimum political risk.

The Economic Policy Council recently reviewed the alternative Farm Bill proposals and defined as unacceptable several approaches being considered by Congress:

- o Mandatory supply controls in any form.
- o Marketing loans (which allow a producer to repay his commodity loan at a lower market price) invite large potential budget exposure with no prospect of this exposure declining over time.
- o Failure to adopt a policy that permits market prices to fall in order to restore export competitiveness.
- o Extending current law, which would continue to make us noncompetitive in world markets and accelerate Federal credit exposure because commercial banks would withdraw more rapidly due to long-term uncertainty.
- o A dairy price support program embodying a dairy diversion program.


James A. Baker III
Chairman Pro Tempore

THE WHITE HOUSE

WASHINGTON

July 31, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: THE ECONOMIC POLICY COUNCIL

SUBJECT: Agricultural Credit Policy

Although it affects only a relatively small group of farmers, a significant portion of outstanding farm credit is in trouble. As of January 1985, 9.9 percent of all farmers had debt to asset ratios over 40 percent and negative cash flow; these farmers owed 45.3 percent of all farm debt. Field crop and livestock operators in the Corn Belt, Lakes States and Southern Plains are facing the greatest financial difficulties.

Without policy changes, the agricultural credit problem will deteriorate rapidly in the next few months. The issue is what, if any, changes the Administration should seek in the operations of the Farmers Home Administration (FmHA), and the Cooperative Farm Credit System (FCS) to ensure the current and future viability of farm credit assistance, without explosively increasing Federal spending.

Origins of the Agricultural Credit Problem

The farm sector is now undergoing an inevitable and necessary correction to the extraordinary agricultural boom of the mid- and late-1970's. Overall demand for U.S farm products grew rapidly, with export markets expanding dramatically. Increased demand, rising productivity, and declining labor inputs caused real income from assets to rise sharply. In response to these incentives, augmented by government farm support programs, the tax code, and negative real interest rates, capital investment in agriculture increased and land values were bid up. Debt rose about as fast as the increase in assets and an increasing share of debt was provided by the Federal Government and the Farm Credit System.

In the 1980's, the boom of the 70s was reversed. The appreciation of the dollar and the slowdown in economic growth abroad slashed exports. The relative decline in demand, combined with several bumper crop years, undermined farm prices. High interest rates over the last six years also reduced income. The less profitable outlook for farming, high real interest rates, and reduced inflationary expectations, pulled down farm land prices and assets while debt rose, squeezing farm equity.

- 2 -

Previous Administration Actions

In response to rising concerns about the deteriorating conditions in farm finances and the adequacy of operating credit, the Administration initiated in September 1984 a series of actions to provide adequate crop loans for 1985. These initiatives, along with greater credit from commercial banks and private individuals, resulted in all but about 5 percent of farmers obtaining operating credit for the current year -- instead of the 15 percent or higher shortfall predicted at the beginning of the lending season.

In February 1985, the Administration made a commitment to increase significantly short-term FmHA direct lending. FmHA currently projects \$4.25 billion will be lent directly by the end of FY 1985, compared with the \$2.57 billion planned in the budget. The guaranteed lending program, after a slow start-up, should commit \$1.1 billion by the end of FY 1985, compared with the \$700 million planned in the budget.

Objectives of Further Actions

The Administration has several objectives in addressing the agricultural credit problem:

- o It should establish a framework in which the flow of credit into the agricultural sector eventually conforms more closely with the market allocation of credit.
- o It should minimize the short- and long-term budget costs of any solution.
- o It should ensure that any credit solution is consistent with our overall agricultural policy.

Farmers Home Administration (FmHA)

The financial problems of the farm sector are adversely affecting the FmHA. From October 1 through June 19 of FY 1985, FmHA provided about \$4.6 billion in direct and guaranteed loans to farmers -- a 92 percent increase over the same period in FY 1984. Direct loans made up 82 percent of the total credit provided. Most of the lending is to new borrowers. About 30 percent of all FmHA loans, or \$8.5 billion, is delinquent. The higher lending in 1985 has increased the loss exposure on these loans.

The dramatic increase in FmHA exposure is due to its position as a "lender of last resort." The FCS and commercial banks are turning away many borrowers and directing them to the FmHA for their operating loans. Although these operating loans are not provided for real estate purposes, they enable the borrower to service his or her existing real estate debt. These loans have become de facto entitlements, which the FmHA virtually cannot foreclose.

- 3 -

Given current conditions, FmHA inhibits the necessary restructuring of the farm sector, which further depresses land values and forces more borrowers out of the FCS and banks and into the FmHA. The potentially large demand for FmHA credit would undermine the Administration's efforts to reduce Federal spending.

Cooperative Farm Credit System (FCS)

The FCS was originally created as a Government-sponsored enterprise. The FCS is able to borrow at about 5-20 basis points above Treasury securities because the market believes its securities are backed by the Federal Government, even though there is no explicit guarantee.

The overall condition of the FCS is basically sound. Of the \$13 billion in stock, retained earnings, and loss allowances, the FCS has \$4 billion to \$6 billion in relatively liquid assets and also holds about \$500 million to \$1 billion of short-term lines of credit.

Notwithstanding the overall sound condition of the FCS, several elements of the system are facing severe financial difficulties. Several problem districts, particularly the Omaha district (including Nebraska, South Dakota, Iowa, and Wyoming), may require a total of about \$1.8 billion within 60-90 days to stabilize their competitive position.

The fundamental problems faced by the FCS are two-fold:

1. The system is highly decentralized and operates on a consensus management basis. Because the FCS' equity is spread among about 900 separate entities and these entities are required to share losses only if there is a technical default, districts requiring additional equity in order to stabilize operations cannot easily draw on the reserves of other districts.
2. The Farm Credit Administration, which oversees the FCS, lacks regulatory authority and the necessary enforcement powers to require acceptable credit standards.

Policy Options

Option 1: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

- 4 -

Advantages

- o Closing the FmHA direct credit window and ending real estate loans minimizes Federal budget outlays which have grown at unprecedented rates.
- o Having the commercial market carry significant portions of the risk on guaranteed loans helps insure the viability of these loans.
- o Having the FCS put itself back on a sound financial basis through loan liquidation and more stringent standards for new loans would help make the flow of agricultural credit more consistent with a market allocation of credit.

Disadvantages

- o This option would curtail some loan activity. More marginal farmers would have to liquidate their assets hastening an already rapid decline in asset values.
- o If FCS were to default on its obligations and were unable to provide credit, the farm sector would face substantial contraction as available credit diminished.
- o Not providing Federal assistance now may result in greater costs of assistance later if it appears the system were going to default in the future.

Option 2: Limit FmHA direct lending to servicing its existing portfolio. Limit FmHA real estate lending to no more than current levels. Continue FmHA guaranteed loans under existing authorities (maximum of 90 percent guarantee) under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

Option 2 differs from option 1 by: permitting FmHA to maintain current levels of real estate lending and maintaining the FmHA loan guarantee level at 90 percent.

Advantages

- o Closing the direct credit window at FmHA eases the short run pressure on budget outlays.
- o Eases the adjustment for farmers by promoting slower transfer of unproductive resources out of agriculture.
- o This approach could be implemented through regulations and, in the case of FCS by their independent action, and would not require Congressional approval.

- 5 -

Disadvantages

- o Absorbing most of the risk on guaranteed loans promotes lower quality loans by commercial lenders, significantly increasing the ultimate Federal budget exposure.
- o Continuing FmHA activity in a deteriorating land market enhances the possibility of long term budget outlays from defaulted real estate loans.
- o Some Agricultural Committee members may feel the Administration has exceeded its regulatory discretion with regard to FmHA and move to block these changes through legislation.
- o If FCS were to default on its obligations and were unable to provide credit, the FmHA could face a substantial increase in demand for loans.

Option 3: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, endorsement powers, and Federal oversight, and establish an insured fund.

The Federal Government would provide a line of credit over and above the current \$250 million or direct Federal financing for FCS from the Treasury.

Option 3 differs from option 1 by providing an additional line of credit from the Treasury to the FCS in exchange for formal restructuring of the FCS and FCA.

Advantages

- o Providing Federal Government financing for the FCS could help achieve the needed reorientation of FmHA.
- o It would permit the FCS and other private institutional lenders to remain a viable and competitive source of credit to individual operators while a new farm policy is implemented over the next three to four years.
- o For the first time, there would be strong accountability for the individual institutions within the FCS.

- 6 -

Disadvantages

- o The direct Federal budget exposure could be substantial with a significant risk that part or all of the direct Federal outlays would not be repaid.
- o Providing the Federal Government financing for the FCS would delay the necessary restructuring of the farm sector.
- o Commercial banks, insurance companies, and other lenders may object that the Federal Government is aiding only one component of the agricultural lending sector, and pressure the Government for access to similar resources.

Option 4: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, enforcement powers, and Federal oversight.

Consider creating a Federally-chartered, privately-owned credit institution (Aggie Mae) to purchase nonperforming farm real estate and equipment loans from any recognized financial institution.

Option 4 differs from option 1 by creating a Federally-chartered, privately-owned credit institution, Aggie Mae.

Advantages

- o Creating an Aggie Mae could help achieve the needed reorientation of FmHA.
- o It would permit the FCS and other private institutional lenders to remain a viable and competitive source of credit to individual operators while a new farm policy is implemented over the next three to four years.
- o This proposal would avoid immediate direct Federal budget outlays and require State governments and private lenders to share the risk (through partial loan guarantees).

Disadvantages

- o Creating an Aggie Mae could inhibit the necessary restructuring of the agricultural sector by providing a new source of subsidized credit to the sector.

- 7 -

- o Creating an Aggie Mae with partial Federal guarantees of problem loans places the Federal Government at an unknown, but potentially large, risk.
- o Creating an Aggie Mae would establish a precedent for other troubled lenders such as thrift institutions to seek a similar dumping ground for problem loans.

Recommendation

The Economic Policy Council unanimously recommends option 2.

Economic Policy Council Decision Memorandum

Agricultural Credit Policy
Summary of Options

_____ Option 1:

Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

_____ Option 2:

Limit FmHA direct lending to servicing its existing portfolio. Limit FmHA real estate lending to no more than current levels. Continue FmHA guaranteed loans under existing authorities (maximum of 90 percent guarantee) under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

The Economic Policy Council unanimously recommends option 2.

_____ Option 3:

Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, enforcement powers, and Federal oversight, and establish an insured fund.

The Federal Government would provide a line of credit over and above the current \$250 million or direct Federal financing for FCS from the Treasury.

- 2 -

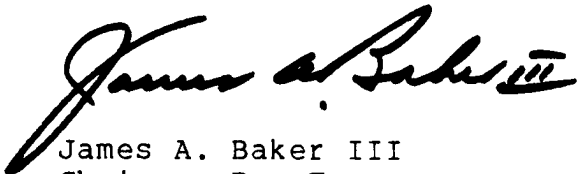
_____ Option 4:

Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, endorsement powers, and Federal oversight.

Consider creating a Federally chartered, privately-owned credit institution (Aggie Mae) to purchase nonperforming farm real estate and equipment loans from any recognized financial institution.

Regardless of any option chosen, the Administration has and should continue to express full confidence in the current financial condition of the Farm Credit System and its ability to continue to meet the challenges of the future.



James A. Baker III
Chairman Pro Tempore